Hydro Québec

Quarterly Report

First Quarter 2006

Message from the Chairman of the Board and the President and Chief Executive Officer

Summary of results

In the first quarter of 2006, income from continuing operations totaled $1,098 million, or $59 million more than in the first quarter of 2005, primarily because of a reduction in financial expenses.

Operating income remained relatively stable at $1,636 million, versus $1,627 million in 2005. This slight increase reflects growth in short-term net electricity exports, but was mitigated by the cost of external supply secured in 2005 for consumption in excess of the heritage pool and by the rise in pension expense on account of the actuarial effect of lower long-term interest rates on financial markets.

Income from discontinued operations was $31 million, up $16 million over 2005, primarily because of the $29-million gain on the sale of our interest in an underwater link, the Cross Sound Cable in the United States. However, we recorded lower net income from our Chilean interest, mainly because of non-recurring exchange gains recognized in 2005.

Net income for the quarter ended March 31, 2006, was $1,129 million, for a year-over-year increase of $75 million.

Consolidated results

Revenue in the first quarter of 2006 totaled $3,213 million, $77 million more than in the first quarter of 2005. This increase was driven mainly by growth in short-term electricity sales outside Québec and, to a lesser degree, higher revenue from sales in Québec.

Total expenditure was $1,577 million, up $68 million over 2005 due to the higher cost of external supply for consumption in excess of the heritage pool and the increase in pension expense. These were partially offset by lower short-term electricity purchases outside Québec.

Financial expenses were $537 million, or $48 million less than in 2005, mainly because of the positive impact of the Canadian dollar's appreciation on interest expense.

Discontinued operations contributed $31 million to net income for the quarter, an increase of $16 million over 2005. This increase was mostly derived from the $29-million gain on the sale in February of our interest in the Cross Sound Cable. This gain was nonetheless mitigated by reduced net income from our Chilean interest, due to higher financial expenses as a result of non-recurring exchange gains recognized in the first quarter of 2005. However, our Chilean interest posted slightly higher current operating results than it did last year.

Segmented results

Generation

In the first quarter of 2006, Hydro-Québec Production earned net income of $807 million, compared to $715 million in 2005. This increase was primarily attributable to the increase in short-term net sales outside Québec.

Transmission

Hydro-Québec TransÉnergie's net income stood at $94 million, up $11 million over last year due to an additional $11 million in transmission service sales volume, bringing total revenue to $632 million in 2006.

Distribution

Hydro-Québec Distribution posted net income of $213 million, compared to $277 million in 2005.

Sales volume was 49.6 TWh, which was relatively stable compared to the first quarter of 2005. The effect of milder temperatures at the beginning of the year was offset by higher baseload demand, chiefly from industrial customers.

Total revenue from electricity sales in Québec was $2,732 million, up $15 million or 0.6% over 2005, essentially as a result of the April 2005 rate adjustment.

Expenditure was up $96 million, mainly because of the cost of the external supply secured in 2005 for consumption in excess of the heritage pool and because of the increase in pension expense.

Construction

The Construction segment comprises the operations of Hydro-Québec Équipement and Société d'énergie de la Baie James.

The volume of activity totaled $366 million, as against $285 million in 2005, for an increase of $81 million. As in 2005, several major projects requiring sizable capital outlay are under way for Hydro-Québec Production and Hydro-Québec TransÉnergie.

Investment

The investment program for 2006 is in excess of $4 billion. Development activities account for almost 60% of this amount, or $2.3 billion, divided up as follows: $1.4 billion for hydro projects—Eastmain-1, Chute Allard/Rapides-des-Coeurs, Peribonka, and Eastmain-1-A/Sarcelle/Rupert—and $900 million to bring the new generating stations onto the grid, meet growth in demand from Québec customers and continue the deployment of the Energy Efficiency Plan. A further $1.7 billion will be earmarked for current operations, such as maintaining and upgrading our assets.

At March 31, 2006, investments in fixed and intangible assets totaled $626 million, compared to $487 million in 2005. As anticipated, a large portion of this amount was devoted to hydro development projects.

In the area of transmission, work to connect the future Eastmain-1 generating station and install de-icing equipment at Lévis substation continued. In distribution, efforts were maintained to meet growth in baseload demand, improve service quality, notably with the Customer Information System (CIS) project, and achieve the objectives of the Energy Efficiency Plan.

Financing

The Corporation's borrowing program for 2006 amounts to $3.1 billion. The proceeds will be used to refinance debt maturing this year and to sustain growth in the investment program.

The Corporation capitalized on demand for its securities and low long-term interest rates by reopening, three times, the bond issue it launched in January 2005, maturing in February 2040. All borrowings were made on the Canadian market. The first two transactions, totaling close to $1.2 billion, were carried out during the first quarter. The third transaction, a $588-million borrowing, was done at the end of March and closed in April. The average cost of these borrowings amounted to 4.9%.

Michael L. Turcotte

Chairman of the Board

Thierry Vandal

President and Chief Executive Officer

May 12, 2006

CONSOLIDATED STATEMENTS OF OPERATIONS

In millions of Canadian dollars
(unaudited)

	Notes	Three months ended March 31 **2006**	2005
Revenue		**3,213**	3,136
Expenditure			
Operations		**569**	542
Electricity and fuel purchases		**363**	332
Depreciation and amortization		**491**	483
Taxes		**154**	152
		1,577	1,509
Operating income		**1,636**	1,627
Financial expenses	2	**537**	585
Income from continuing operations before non-controlling interest		**1,099**	1,042
Non-controlling interest		**1**	3
Income from continuing operations		**1,098**	1,039
Discontinued operations	3	**31**	15
Net income		**1,129**	1,054

CONSOLIDATED STATEMENTS OF RETAINED EARNINGS

In millions of Canadian dollars
(unaudited)

	Three months ended March 31 **2006**	2005
Balance at beginning of period	**13,075**	11,949
Net income	**1,129**	1,054
Balance at end of period	**14,204**	13,003

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED BALANCE SHEETS

In millions of Canadian dollars

	Notes	As at March 31 2006 (unaudited)	As at December 31 2005 (audited)
ASSETS			
Property, plant and equipment		**50,750**	50,588
Current assets			
Cash and cash equivalents		**85**	16
Investments		**99**	322
Accounts receivable		**2,444**	1,764
Swaps and sinking funds		**729**	685
Materials, fuel and supplies		**369**	343
Assets held for sale	3	**157**	145
		3,883	3,275
Other long-term assets			
Investments		**224**	221
Swaps and sinking funds		**1,680**	1,749
Goodwill		**10**	10
Intangible assets		**624**	639
Other assets		**1,810**	1,784
Assets held for sale	3	**2,004**	2,166
		6,352	6,569
		60,985	60,432
LIABILITIES AND SHAREHOLDER'S EQUITY			
Long-term debt		**31,476**	31,279
Current liabilities			
Borrowings		**369**	20
Accounts payable and accrued liabilities		**1,757**	1,929
Dividends payable		**-**	1,126
Accrued interest		**546**	927
Current portion of long-term debt		**3,517**	3,148
Liabilities related to assets held for sale	3	**205**	172
		6,394	7,322
Asset retirement obligations		**289**	282
Other long-term liabilities		**2,698**	2,548
Long-term liabilities related to assets held for sale	3	**1,182**	1,213
Perpetual debt		**379**	379
Non-controlling interest		**34**	33
Shareholder's equity			
Share capital		**4,374**	4,374
Retained earnings		**14,204**	13,075
Translation adjustments		**(45)**	(73)
		18,533	17,376
		60,985	60,432
Commitments and contingencies	6		

The accompanying notes are an integral part of the consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

In millions of Canadian dollars
(unaudited)

	Notes	Three months ended March 31 2006	2005
Operating activities			
Income from continuing operations		**1,098**	1,039
Non-cash items			
Depreciation and amortization			
Property, plant and equipment		**435**	430
Intangible assets		**29**	27
Regulatory assets		**23**	15
Deferred charges		**3**	4
Discounts and other deferred credits related to long-term debt		**(50)**	(22)
Other		**24**	94
Change in non-cash working capital items		**(1,202)**	(933)
		360	654
Investing activities			
Property, plant and equipment and intangible assets		**(626)**	(487)
Long-term investments		**-**	3
Disposal of investments, net of divested cash and cash equivalents		**164**	-
Net change in short-term investments		**223**	60
Other		**(31)**	(34)
		(270)	(458)
Financing activities			
Issuance of long-term debt		**1,394**	2,195
Repayment of long-term debt at maturity and sinking fund redemption		**(579)**	(660)
Inflows resulting from credit risk management		**-**	195
Outflows resulting from credit risk management		**(50)**	(180)
Net change in short-term borrowings		**349**	4
Dividends paid		**(1,126)**	(1,350)
Other		**-**	(2)
		(12)	202
Change in foreign exchange on cash and cash equivalents		**-**	2
Cash flows from continuing operations		**78**	400
Cash flows from discontinued operations	3	**10**	(6)
Net change in cash and cash equivalents		**88**	394
Cash and cash equivalents at beginning of period		**92**	97
Cash and cash equivalents at end of period		**180**	491
Cash and cash equivalents			
Continuing operations		**85**	491
Discontinued operations		**95**	-
		180	491
Supplementary cash flow information	4		

The accompanying notes are an integral part of the consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Three month period ended March 31, 2006 and 2005
Amounts in tables are in millions of Canadian dollars

Note 1 - Basis of Presentation

The consolidated financial statements have been prepared in accordance with Canadian generally accepted accounting principles (GAAP) and reflect the accounting procedures and practices that are generally accepted by the Régie de l'énergie. Given that these procedures and practices are taken into account in the consolidated financial statements, the timing of the recognition of certain costs in consolidated operations is modified, resulting in the recognition of regulatory assets.

The quarterly consolidated financial statements and the present Notes should be read in conjunction with the Consolidated Financial Statements and accompanying Notes in Hydro-Québec's *Annual Report 2005*.

The accounting policies used to prepare the quarterly consolidated financial statements conform to those described in Hydro-Québec's *Annual Report 2005*.

Certain figures of the previous year have been reclassified in order to conform to the presentation adopted in the current year.

The Corporation's quarterly financial results are not necessarily indicative of results for the year on account of seasonal temperature fluctuations. Because of higher electricity demand during winter months, revenue from electricity sales in Québec is higher during the first and fourth quarters, as the charts in the Consolidated Financial Highlights demonstrate.

Note 2 - Financial Expenses

	Three months ended March 31	
	2006	2005
Interest		
Interest on debt securities	**577**	584
Amortization of discounts and borrowing expenses	**2**	9
	579	593
Exchange (gain) loss	**(7)**	22
Loan guarantee fees[a]	**40**	39
	33	61
Less		
Capitalized financial expenses	**68**	62
Net investment income	**7**	7
	75	69
	537	585

a) Guarantee fees paid to the shareholder.

Note 3 - Discontinued Operations and Assets Held for Sale

In 2005, Hydro-Québec adopted a plan to sell off some of its foreign interests. As a result, the related assets and liabilities were classified as being held for sale. The results for these interests are classified under Corporate and Other Activities for the purpose of presenting segmented information. Further to the adoption of this plan, the following transactions took place in 2006 :

On January 18, 2006, Hydro-Québec concluded the sale of its interest in Hidroeléctrica Rio Lajas S.A., through its subsidiary Hydro-Québec International, for a cash consideration of $5 million, giving rise to a loss on disposal which is not significant.

On February 27, 2006, Hydro-Québec concluded the sale of its interest in Cross-Sound Cable Company, LLC, for a consideration of $182 million, giving rise to a $29-million gain on disposal. The transaction includes the sale of units held and the repayment of the loan granted by Hydro-Québec to Cross-Sound Cable Company, LLC.

On March 29, 2006, Hydro-Québec concluded the sale of its interest in MurrayLink HQI Australia Pty Ltd, through its subsidiary HQI Australia Pty Ltd, for a cash consideration of $60 million. This transaction gave rise to a $4-million loss on disposal, recorded in the first quarter.

Also, on July 15, 2005, Hydro-Québec concluded the sale of the principal assets held by its subsidiary HydroSolution, Limited Partnership, for a cash consideration of $92 million, resulting in a gain on disposal of $48 million. HydroSolution was part of the Distribution segment, for the purpose of presenting segmented information.

The following table presents operating results and cash flows from interests presented as discontinued operations:

	Three months ended March 31	
	2006	2005
Operations		
Revenue	**92**	76
Income before gains on disposal	**6**	15
Gains on disposal	**25**	-
Income from discontinued operations	**31**	15
Cash flows		
Operating activities	**35**	10
Investing activities	**(17)**	(16)
Financing activities	**(9)**	(1)
Change in foreign exchange on cash and cash equivalents	**1**	1
Cash flows from discontinued operations	**10**	(6)

The assets and liabilities of operations sold, as at the disposal date, were as follows:

Cash and cash equivalents	**4**
Other current assets	**8**
Long-term assets	**211**
Current liabilities	**109**
Long-term liabilities	**20**
	94

Note 4 - Supplementary Cash Flow Information

	Three months ended March 31	
	2006	2005
Change in non-cash working capital items		
Accounts receivable	**(559)**	(405)
Materials, fuel and supplies	**(26)**	(2)
Accounts payable and accrued liabilities	**(235)**	(151)
Accrued interest	**(382)**	(375)
	(1,202)	(933)
Investing activities not affecting cash		
Increase in property, plant and equipment and intangible assets	**9**	1
Cash and cash equivalents paid during the year		
Interest paid	**923**	857

Note 5 - Employee Future Benefits

	Three months ended March 31			
	Pension Plan		Other plans	
	2006	2005	**2006**	2005
Accrued benefit cost	**74**	41	**24**	20

Note 6 - Commitments and Contingencies

As at March 31, 2006, the potential maximum amount the Corporation could have to pay under letters of credit or guarantees totaled $410 million. Of this amount, $313 million relates to the purchase of energy, for which a liability in the amount of $23 million has been recorded. Some guarantees expire between 2006 and 2019, while others do not have maturity dates.

Note 7 - Segmented Information

During the quarter ended March 31, 2006, a Technology Group was formed, basically covering activities related to technology and telecommunications development. These activities are presented under Corporate and Other Activities and comprise the transmission system telecommunications activities previously included in the Transmission segment.

The corresponding information has been reclassified in order to conform to the presentation adopted in the current year.

Three months ended
March 31, 2006

	Generation	Transmission	Distribution	Construction	Corporate and Other Activities	Intersegment eliminations	Total
Revenue							
External customers	434	9	2,750	-	21	(1)	**3,213**
Intersegment	1,387	623	14	366	261	(2,651)	-
Income (loss) from continuing operations	807	94	213	-	(15)	(1)	**1,098**
Discontinued operations	-	-	-	-	31	-	**31**
Net income (loss)	807	94	213	-	16	(1)	**1,129**
Total assets	27,793	15,633	10,949	247	6,606	(245)	**60,985**

Three months ended
March 31, 2005

	Generation	Transmission	Distribution	Construction	Corporate and Other Activities	Intersegment eliminations	Total
Revenue							
External customers	401	5	2,731	-	17	(18)	3,136
Intersegment	1,349	617	13	285	250	(2,514)	-
Income (loss) from continuing operations	715	83	276	-	(34)	(1)	1,039
Discontinued operations	-	-	1	-	14	-	15
Net income (loss)	715	83	277	-	(20)	(1)	1,054
Total assets	28,596	15,270	10,595	259	6,446	(186)	58,980

Note 8 - Subsequent Event

On April 18, 2006, the Régie rendered a decision authorizing the Transmission Provider to modify its electricity transmission rates retroactively to January 1, 2005. The main impact of the decision is a $170-million increase in the amount paid for the transmission services needed to deliver electricity to Québec customers. The Régie had already authorized the Distributor to take this increase into account in its next rate filings.

CONSOLIDATED FINANCIAL HIGHLIGHTS

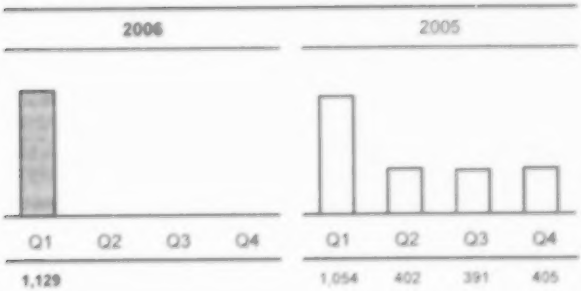
In millions of Canadian dollars
(unaudited)

Three months ended
March 31

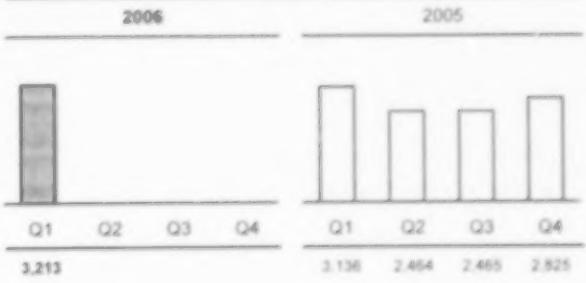
Summary of Operations

	2006	2005	Change (%)	
Revenue	3,213	3,136	2.5	↑
Expenditure	1,577	1,509	4.5	↑
Financial expenses	537	585	8.2	↓
Non-controlling interest	1	3	66.7	↓
Discontinued operations	31	15	106.7	↑
Net income	1,129	1,054	7.1	↑

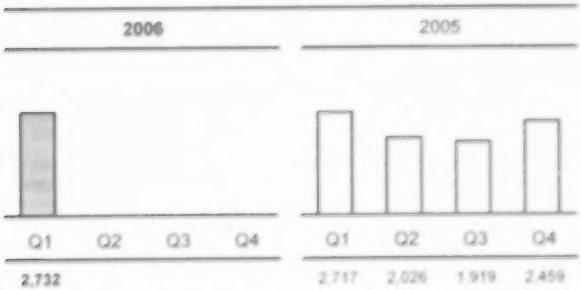
Net Income



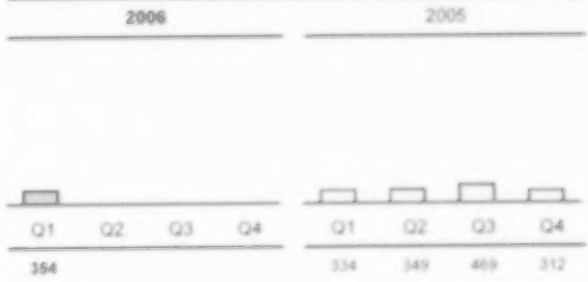
Revenue



Revenue from Electricity Sales in Québec



Revenue from Electricity Sales Outside Québec



Quarter Highlights

Rate-setting

In setting the electricity rates for 2006–2007, the Régie de l'énergie recognized the increase in supply costs and the importance of rates that give a true price signal. After an average 5.3% increase, the new rates (in effect since April 1, 2006) will add $4.95 to the average residential customer's monthly bill. Hydro-Québec Distribution will continue its efforts to promote energy efficiency and to help its customers reduce their electricity consumption. In fall 2005, the Distributor raised its target for recurring energy savings from 3 to 4.1 TWh, to be reached by 2010.

Energy Efficiency Plan budget

On March 30, the Régie approved a budget of $170.9 million for the Energy Efficiency Plan (EEP) filed by Hydro-Québec Distribution for 2006. It approved the new Plant Retrofit program, which should generate recurring savings of 500 GWh by 2010, and the adaptation of EEP programs for customers in off-grid systems. It asked the division to consider the special needs of low-income households and to enhance the programs offered to these customers. It also asked the division to step up its efforts to encourage business customers, especially in the institutional sector, to participate in energy efficiency programs.

Wind integration

In February, the Régie approved an agreement for the integration of 990 MW of wind power into the grid. The agreement, signed by the Distributor and the Generator on June 9, 2005, provides for balancing and firming services for the wind energy brought on stream as a result of the Distributor's May 2003 call for tenders.

Customer generation

In February, the Régie approved the rates and conditions of service for on-site generation by residential and commercial customers. The decision enables self-generators to improve the profitability of their generating equipment. Only renewable sources such as wind, hydro, photovoltaic solar, biogas and forest biomass are eligible. Customers may feed their surpluses into the Distributor's grid; these surpluses will be credited to their account, thus reducing their electricity bill during periods when their consumption exceeds their output.

Connection of three generating stations

Péribonka. On February 1, 2006, the Régie authorized Hydro-Québec TransÉnergie to connect Péribonka generating station (385 MW, under construction) to the power system. A 161-kV double-circuit line about 120 km long will connect the switchyard to the grid via the new Simard substation. The project is estimated at $184.5 million and is scheduled to come online March 1, 2008.

Chute-Allard and Rapides-des-Cœurs. In March, the Régie authorized Hydro-Québec TransÉnergie to connect Chute-Allard and Rapides-des-Cœurs generating stations to the power system. This $104.5-million project consists in building a 230-kV single-circuit line 30 km long between these two generating stations and a 31.4-km line between Rapides-des-Cœurs and Rapide-Blanc. It will also require the addition of series compensation at Des Hêtres substation and other related work. Commissioning of the first units will take place in November 2007 at Chute-Allard and one month later at Rapides-des-Cœurs.

Sale of three holdings

In January, Hydro-Québec sold its stake in Hydroeléctrica Río Lajas S.A. of Costa Rica to Corporación de Inversiones Abonos Superior, S.A., its Costa Rican partner.

In February, Hydro-Québec sold its stake in Cross-Sound Cable Company, LLC to Babcock & Brown Infrastructure Ltd for US$160 million (C$182 million), realizing a gain of C$29 million. The 24-km, 330-MW underwater cable links New Haven, Connecticut, to Brookhaven, Long Island, NY.

In March, Hydro-Québec sold its stake in the Australian interconnector owner MurrayLink HQI Australia Pty Ltd to Australian Pipeline Trust for AU$72 million (C$60 million). Hydro-Québec and SNC-Lavalin had been joint owners since 2002 in the 180-km underground link between the states of Victoria and South Australia.

Generations Fund

On March 23, the Québec government announced the creation of a "Generations Fund" for reduction of the provincial debt. Hydro-Québec will contribute to the fund by paying water royalties and a portion of the profits from exports (the latter is currently under study). As provided for in the *Watercourses Act*, water royalties in 2006 are $3.28 per 1,000 kilowatthours of generation, and are adjusted annually to the rise in the Consumer Price Index.

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